Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Alquist, et al Analyst: Jeff Garnier Bill Number: AB 2281

Related Bills: See Legislative History Telephone: 845-5322 Amended Date: 2/24 & 3/30/2K

Attorney: Patrick Kusiak Sponsor: State Controller

SUBJECT: Long-Term Care Insurance Deduction

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ________________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED ____________ STILL APPLIES.

_____ OTHER - See comments below.

SUMMARY OF BILL

This bill would provide that 25% of the cost of long-term care insurance would be allowed as a deduction in computing adjusted gross income (AGI). The credit would be starting in the 2002 tax year and increase incrementally to 100% beginning in the 2007 tax year. The deduction would not be allowed for single or married filing separate taxpayers with AGI greater than $100,000 and all other taxpayers with AGI greater than $200,000.

SUMMARY OF AMENDMENT

The bill, as originally introduced on February 24, 2000, effectively would have removed the limitation, based on age, on long-term insurance medical expense deduction.

The proposed amendments added the AGI limitation and changed the character of the deduction from an itemized deduction to an "above the line" deduction in computing AGI.

EFFECTIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and apply to taxable years beginning on or after January 1, 2002.

LEGISLATIVE HISTORY

AB 2096 (2000) would provide for a $500 credit to taxpayers providing long-term care to elderly individuals who reside with the taxpayer. AB 2268 (2000) would allow a $500 credit to taxpayers for providing long-term care to the taxpayer, taxpayer's spouse or a dependent of the taxpayer who is certified as needing long term care.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP	Alan Hunter for GHG	4/5/00
_____ SA	_____ O	_____ NAR		
_____ N	_____ OUA	__X__ PENDING		

SPECIFIC FINDINGS

Under **federal tax law** long-term care services are defined as services necessary to diagnose, prevent, cure, treat, mitigate, rehabilitate and maintain or to provide personal services to a chronically ill individual. A chronically ill individual is generally defined as an individual certified annually by a licensed health care practitioner as being unable to perform (without substantial assistance) at least two of the following activities of daily living (ADLs): eating, toileting, transferring, bathing, dressing and continence or requires substantial supervision to protect such individual from health and safety concerns due to severe cognitive impairment.

Current **federal tax law** specifically allows a medical expense deduction for the unreimbursed expenses for qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents.

Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

Long-term care insurance premiums, like medical care insurance premiums, are explicitly treated as medical expenses and are deductible on a graduated scale based on the individual's age as of the last day of the taxable year.

Age of Individual	Maximum Deduction
40 or less	$200
More than 40 but less than 50	375
More than 50 but less than 60	750
More than 60 but less than 70	2,000
More than 70	2,500

Generally, under **current law** all medical expenses, including direct out of pocket medical expenses, health insurance, long-term care expenses and insurance, are added together and only the amount greater than 7.5% of AGI is deductible as an itemized deduction.

Current law also excludes from gross income of the employee any employer contributions to accident and health plans, except for contributions to cafeteria plans or "flexible spending arrangements," as defined. In addition, current law excludes from gross income the receipt of benefits from long-term care insurance.

Current **federal law** imposes an information reporting requirement on insurance companies paying long-term care benefits. In addition to the normal reporting requirements (identification of recipients and amounts paid out by the company), the insurance company also must include the type of policy issued to the recipient. A penalty excise tax may be imposed on issuers of long-term care insurance companies that fail to satisfy the above requirements.

Current **California tax law** conforms to federal tax law concerning long-term care and medical expenses.

This bill, as proposed to be amended, would permit the deduction of long-term care insurance as an above the line deduction in computing AGI. This bill would phase in the deduction of long-term care insurance to 100% as follows:

Beginning In	Long-Term Care Insurance Deductible
2002	25%
2003	40%
2004	55%
2005	75%
2006	85%
2007 and thereafter	100%

This bill would provide that no deduction would be allowed if the taxpayer's employer paid or incurred more than 50% of the cost of the long-term care insurance.

This bill would provide that an "above the line" deduction would not be allowed for single or married filing separate taxpayers with AGI greater than $100,000 and all other taxpayers with AGI greater than $200,000.

Under **this bill,** during the phase-in period between the years 2002 and 2007, any amount paid for long-term care insurance not allowed as a deductible expense under this bill would still be allowed as a medical expense (subject to present law limitations).

Policy Considerations

This credit would not be limited to taxpayers or applicable individuals who reside in California.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 2281 As Proposed To Be Amended [$ In Millions]						
2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Minor loss	-$6	-$12	-$20	-$31	-$42	-$56*

*when the bill is fully implemented

Estimates above assume the bill would be effective with taxable years beginning on or after January 1, 2002. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The amount of deductible premiums and the marginal tax rate of taxpayers with policies in force would determine the revenue impact of this bill.

The estimate was derived primarily in the following steps:

1. Projected the net number of California resident taxpayers insured: approximately 425,000 by 2002;
2. Estimated an average annual premium of $1,700;
3. Estimated the portion of total premiums attributed to taxpayers whose AGI is $100,000/$200,000 or less (single/joint);
4. Calculated and applied an “inducement to purchase” rate that increases incrementally each year;
5. Determined an average marginal tax rate for California taxpayers with long-term care (LTC) policies in force and who benefit from the proposed deduction (6.5%); and
6. Estimated offsetting revenue gains resulting from the proposed deduction (for AGI) replacing the present medical expense deduction (from AGI).

Based on national data for 1996, the number of LTC policies in force for California residents was estimated at 275,000. The number of total policies grows each year by the net of new policies purchased and policies that lapse for both mortality and non-mortality reasons. The number of policies in California is projected to grow to roughly 425,000 by 2002.

For the estimate, an average premium of $1,700 annually is used. Multiplying the number of policies by the average annual premium derives total premiums. A policy’s annual premium is a function of many variables including the type of policy and coverage selected, age, health status, and the cost of care in the area where one resides. The younger one is the lower the premiums. According to one of the top ten providers of long-term care insurance, most LTC insurance policy premiums can range from $1,000 to $3,000 annually. Employer-paid premiums are estimated to be very insignificant.

Tax return data arrayed by AGI class was used to estimated the portion of total premiums attributed to taxpayers whose AGI is $100,000/$200,000 or less (single/joint).

Because the proposed deduction effectively reduces the annual cost of a LTC policy, an “inducement to purchase” rate was calculated and applied. The rate increases incrementally each year to reflect the phase-in of the proposed deduction and also taxpayer behavior.

Additional reduction adjustments were applied to: (1) reflect a “participation rate” of less than 100% in the initial years and (2) reflect offsetting revenue gains as the proposed deduction is in place of the present law deduction. The “participation rate” adjustment accounts for taxpayers who would be eligible for the proposed deduction but would not report it for one reason or another.

Applying a marginal tax rate of 6.5% derived the liability year estimates. The average marginal tax was calculated by performing a simulation using sample tax return data. Liability year estimates were converted to the cash-flow estimates above. Cash flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

BOARD POSITION

Pending.